Office of Chief Counsel
Internal Revenue Service

# memorandum

CC:WR:SCA:LN:TL-N-1023-99
AHLee

date: APR 02 1999

to: Chief, Examination Division, Southern California District
Attention: Ken Ficklin, Group Manager CE 117

from: Andrew H. Lee, Attorney
June Y. Bass, Assistant District Counsel
Southern California District Counsel, Laguna Niguel

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subject: [redacted]

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## ISSUE

By a memorandum dated February 9, 1999, you requested advice in a case involving the above-referenced taxpayer. This memorandum responds to your request. You have essentially posed two questions:

1) Whether payments of contingent interest made to the taxpayer were constructive dividends; and

2) Whether the taxpayer should be allowed to accrue contingent interest in the taxable year ended March 31, [redacted], when no event triggering the payor's obligation to pay contingent interest occurred during that year.

**CONCLUSION**

Based upon the facts presented, we recommend that the Examination Division go forward with the recharacterization of the advances at issue to capital contributions. [redacted], (k)(5), (b)(5)(AC) [redacted]. We agree that the taxpayer may not take a deduction for the taxable year ended March 31, [redacted], for interest which it did not become liable to pay until after March 31, [redacted].

[redacted], (b)(5)(AC) [redacted]. [redacted] to our National Office for review as a Non-Significant Advice Request. Should our National Office recommend that we modify our advice, we will inform you.

**FACTS**

The taxpayer, [redacted], is a consolidated group engaged in various activities. The periods at issue are the taxable years ended March 31, [redacted], and March 31, [redacted].[1]

Prior to [redacted], the taxpayer and another corporation, [redacted] ("[redacted]") owned [redacted]% and [redacted]%, respectively, of a corporation called [redacted] ("[redacted]"). [redacted] was created for the purpose of allowing [redacted] and [redacted] to together engage in real estate

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[1]Unless specifically noted, we have relied upon facts presented to us orally and in writing by the Examination Division. Our advice might be different if the facts were different. If the facts which we recite in this memorandum ultimately prove to be inconsistent with your understanding of the facts, or if we have recited facts of which you are not aware, contact this office immediately and do not rely on this memorandum.

development activities. [redacted] has never had any employees of its own and has relied on its shareholders for the performance of its functions. [redacted] was controlled by an individual named [redacted]. At some point, [redacted] changed its name to [redacted] ("[redacted]"). [redacted]s shareholders had capitalized [redacted] with a total of $[redacted] of cash. On [redacted], the taxpayer sold a [redacted]% interest in [redacted] to [redacted], making [redacted] the [redacted]% shareholder.

On [redacted], [redacted] entered into a Joint Venture Agreement with [redacted] ("[redacted]"). The Joint Venture Agreement created a partnership called [redacted] ("[redacted]"). [redacted] became a general partner of [redacted] and had an [redacted]% interest in the partnership. [redacted] held the remaining [redacted]% interest in the partnership. [redacted] was created for the purpose of constructing [redacted] housing units. [redacted] and [redacted] initially agreed that [redacted] would be capitalized with $[redacted] from [redacted] and $[redacted] from [redacted].

The Joint Venture Agreement provided that operating cash flow was to be distributed to [redacted] and [redacted], first in an amount per year equal to [redacted]% of each partner's capital contribution. The remaining cash flow was to be paid [redacted]% to [redacted] and [redacted]% to [redacted].

[redacted] expected to receive payments of administrative and management fees from the [redacted] of the State of [redacted] ("[redacted]"). According to a letter dated [redacted], from [redacted] to [redacted] (the "First Letter"), [redacted] was to pay [redacted]% of any such amounts to [redacted] and [redacted]% to [redacted]. The letter further described these payments as guaranteed payments as defined at I.R.C. § 707(c).

The agreement to make these payments to [redacted] and [redacted] was also memorialized in a letter dated [redacted], from [redacted] to the taxpayer and to [redacted] (the "Second Letter").[2] This letter, which described most of the transaction at issue, further indicated that [redacted] would pay [redacted]% of its share of the [redacted] fees to [redacted] and [redacted]% to the taxpayer. The remaining [redacted]% of [redacted] fees would remain with [redacted].

The Second Letter also provided that [redacted] would perform all services which [redacted] was obligated to perform under the Joint Venture Agreement between [redacted] and [redacted]. The Second Letter

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[2]The letter was signed by representatives of [redacted], the taxpayer, and [redacted].

further recited that the agreed upon allocation of the [redacted] fees ([redacted]% to [redacted] and [redacted]% to the taxpayer) represented all the compensation or reimbursement to be received by the taxpayer and [redacted], "unless such compensation or reimbursement [was] expressly provided for under the Joint Venture Agreement or is otherwise agreed upon by the parties in writing."

The Second Letter further provided that the taxpayer was to loan $[redacted] to [redacted]. [redacted] was obligated to repay this amount only out of distributions paid by [redacted] to [redacted]. [redacted]% of any such payments would represent what the parties labeled, "contingent interest."

The Second Letter went on to provide that the taxpayer would lend $[redacted] to [redacted]. [redacted] was required to lend to [redacted] the $[redacted] which the taxpayer had loaned to [redacted]. The taxpayer had the option of advancing the $[redacted] directly to [redacted], rather than having the amount pass through [redacted]'s hands. [redacted] was obligated to repay the loan from [redacted] only out of distributions paid by [redacted] to [redacted]. [redacted]% of any such payments from [redacted] to [redacted] would represent contingent interest payable to [redacted].

Under the anticipated terms of the loan between the taxpayer and [redacted], [redacted] was to pay the taxpayer interest at [redacted]%. We have not been furnished with a copy of the note and therefore rely on the description in the Second Letter. The note was to be payable within [redacted] years, or within [redacted] months of the sale of the last unit of the [redacted] project, whichever came first. The loan between the taxpayer and [redacted] would be recourse and would have to be repaid regardless of whether distributions from [redacted] to [redacted] were sufficient to service the loan. [redacted] was to pledge the indebtedness of [redacted] to [redacted] as security for its loan from the taxpayer, and [redacted] personally guaranteed the loan between the taxpayer and [redacted].

According to the Second Letter, [redacted] was to take the $[redacted] loaned to it by the taxpayer and [redacted] and contribute it to the capital of [redacted]. This $[redacted] would represent part of the $[redacted] of capital which [redacted] was required to contribute to [redacted] pursuant to the Joint Venture Agreement. The taxpayer had the option of advancing the $[redacted] (including the $[redacted] to be loaned to [redacted]) directly to [redacted].

The note between [redacted] and the taxpayer (the "[redacted]/Taxpayer Note") is dated [redacted]. It varied somewhat from the terms described in the Second Letter. The [redacted]/Taxpayer note provided for a [redacted] year rather than a [redacted] year maturity period. The principal amount was reduced from $[redacted] to $[redacted].[3] [redacted]% of distributions received by [redacted] from [redacted] were to be paid to the taxpayer as contingent interest.

The [redacted]/Taxpayer Note had other details not fully described in the Second Letter. Section 2.2 of the [redacted]/Taxpayer Note provided that contingent interest payments were to be made in accordance with Section 3 of the [redacted]/Taxpayer Note. Section 3 of the [redacted]/Taxpayer Note provided that payments from [redacted] to the taxpayer were to be first allocated to principal. After both the taxpayer and [redacted] received full payment of principal, [redacted]% of any subsequent distributions from [redacted] to [redacted] was to be paid to the taxpayer as contingent interest. The [redacted]/Taxpayer Note provided that to the extent any interest payable under the note would be usurious under Federal or California law, the usurious portion would be reallocated to principal. Finally, the note was non-recourse, and repayment could only come from the distributions from [redacted] to [redacted], as described under Section 3 of the note.

The terms of the note between [redacted] and [redacted] (the "[redacted]/[redacted] Note"), also dated [redacted], were essentially identical to the terms of the [redacted]/Taxpayer Note. The [redacted]/[redacted] Note varied from the terms described in the Second Letter in the same manner as the [redacted]/Taxpayer Note varied from the Second Letter's description. The [redacted]/[redacted] Note provided for a principal amount of $[redacted]. The [redacted]/[redacted] Note in effect provides that after principal is paid, [redacted]% of distributions from [redacted] to [redacted] will be paid to [redacted] as contingent interest.

On [redacted], the taxpayer repurchased the [redacted]% interest in [redacted] which it had sold to [redacted]. This purchase left the taxpayer as the [redacted]% shareholder.

At some point after [redacted], [redacted] issued revised promissory notes to the taxpayer and to [redacted]. The revised promissory notes were dated [redacted]. The revenue agent assigned to this case believes that the revised promissory notes were back-dated, because the taxpayer booked interest income consistent with the original [redacted]/Taxpayer Note for some time after [redacted].

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[3]The capital requirements of [redacted] apparently had declined between [redacted], and [redacted].

The revised promissory note between [redacted] and the Taxpayer (the "Revised [redacted]/Taxpayer Note") is essentially identical to the original note, except for the allocation of payments between principal and interest. Section 2.2 of the Revised [redacted]/Taxpayer Note states, in part:

> In accordance with the provisions of Section 3 of this Note, and before the principal amount of this Note has been paid in full, Borrower shall pay to Lender concurrently with, or not later than five (5) business days after any distributions are received by Borrower from [redacted] . . . as interest on the loan, an amount (the "Contingent Interest") equal to [redacted]% for Lender . . .

Section 3 of the Revised [redacted]/Taxpayer Note, however, was unchanged from the original [redacted]/Taxpayer Note and still provided that principal would be paid first.[4] The revised promissory note between [redacted] and [redacted] (the "Revised [redacted]/[redacted] Note") varied from the original [redacted]/[redacted] Note in the same manner as the Revised [redacted]/Taxpayer Note varied from the original [redacted]/Taxpayer Note.

The taxpayer had loaned other amounts to [redacted]. The revenue agent assigned to this case believes that those notes were recourse notes and were therefore higher in priority than the notes described above.

On [redacted], [redacted] (f.k.a. [redacted]) sold its interest in [redacted] to the taxpayer for [redacted]'s original cost. After that date, [redacted] continued to receive payments under the [redacted]/[redacted] Note or the Revised [redacted]/[redacted] Note. [redacted] then became a member of the taxpayer's consolidated group, and its income was reported on the taxpayer's consolidated return for the period ended March 31, [redacted]. The taxpayer and [redacted] are accrual method taxpayers.

At some point prior to [redacted], [redacted], the accounting firm which now represents the taxpayer, asked [redacted] whether the [redacted]% of distributions from [redacted] to [redacted] which [redacted] (formerly [redacted]) was receiving was really interest. [redacted] replied that only [redacted]% of the

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[4]Thus, under the revised note, payments were still allocated first to principal. It seems that the parties' carelessness in drafting the revised note caused it to change nothing.

distributions from [redacted] was interest and that the remaining [redacted]% was compensation for services.[5]

The venture enjoyed tremendous success. In [redacted], [redacted] received a distribution of $[redacted] from [redacted]. This distribution was almost [redacted] the total principal outstanding. In [redacted], [redacted] received a distribution of $[redacted]. In [redacted], [redacted] received a distribution of $[redacted]. In [redacted], [redacted] received a distribution of $[redacted]. In [redacted], [redacted] received a distribution of $[redacted]. The distributions received by [redacted] totaled $[redacted]. $[redacted] of this amount would be paid to the taxpayer and [redacted].

On [redacted], [redacted] issued a check to the taxpayer in the amount of $[redacted]. This payment included $[redacted] of principal on the [redacted]/Taxpayer Note, $[redacted] of principal on another note issued to the taxpayer, $[redacted] of contingent interest, and $[redacted] of repayment for amounts loaned by the taxpayer to [redacted] (formerly [redacted]). The revenue agent assigned to this case believes that the parties to the loans prepared the revised notes at some point after the [redacted], payment. The payments made by [redacted] to the taxpayer after [redacted], were all allocated to interest. The taxpayer also reclassified the principal included in the [redacted], payment to interest. The taxpayer has produced a document showing handwritten corrections to the schedule allocating the [redacted], payment. Based upon the parties' revised allocation of interest and principal, the taxpayer has paid no principal whatsoever. It does not appear that the taxpayer has yet claimed a bad debt deduction for the advances at issue.

For the taxable year ended March 31, [redacted], the taxpayer accrued and deducted $[redacted] of management expenses. The $[redacted] represented [redacted]% of the $[redacted] guaranteed payment the taxpayer had received from [redacted].[6] For the taxable

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[5]The [redacted]% figure was arrived at by assuming that all [redacted]% of distributions from [redacted] received by the taxpayer was interest. [redacted]% of distributions bears the same ratio to $[redacted] (the principal owed to [redacted]) as [redacted]% of distributions bears to $[redacted] (the principal owed to the taxpayer).

[6]The [redacted]% is the sum of the [redacted]% to be paid to [redacted] and the [redacted]% to be paid to the taxpayer. It is unclear what services the taxpayer performed to be entitled to such payments.

year ended March 31, [redacted], the taxpayer accrued and deducted $[redacted] of management expenses.

## DISCUSSION

### I. - Contingent Interest

Payments may be classified as interest for income tax purposes, even if contingent on a borrower's profitability. "It is not essential that interest be computed at a stated rate, but only that a sum definitely ascertainable shall be paid for the use of borrowed money, pursuant to the agreement of the lender and borrower. Except for the usury laws of the several states, there is no limit set upon the amount of interest which may be paid under specific contract between the creditor and the debtor." Kena v. Commissioner, 44 B.T.A. 217 (1941). In Kena, payments equal to 80% of net profits of a borrower were held to be interest for the purpose of determining whether the lender, which was owned by the borrower, qualified as a personal holding company. "There is no requirement . . . that deductible interest be ordinary and necessary or even that it be reasonable." Dorzback v. Collison, 195 F.2d 69 (3rd Cir. 1952). In Dorzback, payments equal to 25% of the taxpayer's net profits to the taxpayer's wife were held to be deductible interest, even though the payments exceeded the underlying indebtedness.

Even the Service has taken the position that contingent interest, when reasonable in amount, is still interest for income tax purposes. In Revenue Ruling 76-413, 1976-2 C.B. 213, the Service considered whether enough of the taxpayer's income was interest to allow the taxpayer to qualify as a real estate investment trust. The Service concluded that the taxpayer qualified, because where a loan agreement provided for interest at a fixed rate of 11%, plus 1.75% of the gross receipts from the sale of land or $300 per acre, and where the payments were not usurious, the payments could be considered to be interest.

Courts have, nonetheless, determined that payments labeled as interest were not really interest where factors in addition to contingency were present. See, e.g., Talbot Mills v. Commissioner, 3 T.C. 95 (1944), aff'd 146 F.2d 809 (1st Cir. 1944), aff'd 326 U.S. 521 (1946). In Talbot Mills, the shareholders of a family-controlled corporation exchanged their stock for notes. The notes were contingent on the earnings of the corporation. In addition, the notes were subordinate to other indebtedness, the shareholders could defer payment of interest, and the exchange of stock for notes was primarily tax motivated. The Tax Court and the First Circuit held that the notes really represented equity, and the Supreme Court deferred to the Tax Court's findings of fact. Therefore, it is possible, with the right facts, to recharacterize interest as dividends.

There are arguably four ways of challenging the taxpayer's transaction. The first way consists of recharacterizing part of the contingent interest payments as distributions, pursuant to section 482, on the ground that the interest rate was not comparable to an arm's length rate of interest. The second way is to argue that in substance the contingent interest payments were not entirely payments of interest deductible under section 163. The third way consists of recharacterizing the loans to [redacted] as contributions to capital. This method would cause all payments to [redacted]'s shareholders to be either distributions or compensation for services. The fourth way consists of relying on the section of the notes providing that interest would be reclassified to principal if the rate proved to be usurious.

**A. Recharacterizing Contingent Interest as Dividends**

I.R.C. § 482 provides in part that in the case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

The 1968 section 482 regulations govern taxable years beginning on or before October 6, 1994. Subsequent periods are governed by the 1994 section 482 regulations. Treas. Reg. § 1.482-1(j)(1). In this case, the taxable year ended March 31, [redacted], is subject to the 1968 regulations. Fortunately, the relevant portions of the 1968 regulations are worded identically to the analogous provisions of the 1994 regulations. Our discussion will therefore apply equally to the taxable years ended March 31, [redacted], and March 31, [redacted].

Treas. Reg. § 1.482-2(a)(1)(i) provides in part that where one member of a group of controlled entities makes a loan or advance to another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest, the Service may make an appropriate allocation to reflect an arm's length rate of interest. Treas. Reg. § 1.482-2(a)(1)(ii)(B) provides that the general rule does not apply to so much of an alleged indebtedness which is not in fact a bona fide indebtedness.

It is unclear whether the taxpayer and [redacted] were commonly controlled for purposes of section 482 when the terms of the notes were negotiated, or whether [redacted] and [redacted] were commonly controlled when the notes were negotiated. Common control is a question of fact, and the shifting ownership of [redacted] presents a problem. It appears that the taxpayer and [redacted] caused [redacted] to become the controlling shareholder of [redacted] prior to the making of the advances to [redacted]. It then appears that the taxpayer became the controlling shareholder after the making of the advances to [redacted]. We do not know if the parties to the transaction caused the ownership to shift for the purpose of circumventing section 482. At this point, in part because of the shifting ownership, we do not have sufficient facts to establish that [redacted] and the taxpayer or [redacted] and [redacted] were commonly controlled at the time the original notes were signed.

Other factors cause us to doubt whether the Service may make a successful case for a section 482 reallocation. In this case, the Service would have difficulty establishing that the effective interest rate agreed to by the parties was not at arm's length. The problem is that we cannot establish that the parties to the transaction knew when they agreed to it that the interest rate would be as high as it was. The purpose of the payments by the taxpayer and [redacted] to [redacted] was to permit [redacted] to engage in a real estate development activity. Such activities are inherently extremely risky, and we have no evidence indicating that the parties were aware of how high the return on investment would be. If the parties had known how profitable the venture would be, they probably could have saved themselves a lot of trouble by becoming direct partners in [redacted]. We cannot say that a party at arm's length, at the time the transaction was negotiated, would not have demanded the same kind of potential return on investment.

Both the control issue and the difficulty of showing that the terms of the transaction were not comparable to arm's length terms jeopardize a successful section 482 argument. Accordingly, we do not recommend reliance on a section 482 theory to make an adjustment to the taxpayer's income.

**B. Substance Over Form**

Another option is to assert that the contingent interest payments were excessive and could not be viewed in substance as payments of interest. Under this theory, the excessive payments would be recharacterized as dividends. This theory is different from recharacterizing the loans as contributions to capital, because under this theory, some of the payments would still be considered as interest.

It appears that courts, in reclassifying interest to dividends, have relied on a finding of fact that the underlying obligation was equity. See, e.g., Farley Realty Corporation v. Commissioner, 279 F.2d 701 (2nd Cir. 1960). (b)(5)(AC) [redacted]

### C. Recharacterizing Debt as Equity

The Service may have a stronger case if it asserts that the loans from the taxpayer and [redacted] to [redacted] were in fact contributions to capital. The Ninth Circuit has identified a number of factors which distinguish debt from equity. They include:

1) The names given to the certificates evidencing the debt or equity;
2) The presence or absence of a maturity date;
3) The source of the payments;
4) The right to enforce payment of principal and interest;
5) Participation and management;
6) A status equal to or inferior to that of regular corporate creditors;
7) The intent of the parties;
8) "Thin" or adequate capitalization;
9) Identity of interest between creditor and stockholder;
10) Payment of interest only out of "dividend" money; and
11) Ability to obtain loans from outside lending institutions.

Hardman v. U.S., 827 F.2d 1409 (9th Cir. 1987) (transfer of property to corporation treated as sale rather than capital contribution because consideration of the various factors weighed against finding a capital contribution).

The first of the eleven factors favors finding debt rather than equity. The documents governing the transaction are labeled as notes and contain language typical of notes.

The second factor is difficult to apply in this case. The notes each provide for a [redacted] year maturity period, but [redacted] is not required to make a payment at the end of [redacted] years, and it is unclear what would happen to the purported loan if [redacted] were unable to fully repay it within [redacted] years. A court, however, may still find that there is a fixed maturity date if repayment is tied to a fairly certain event, such as the sale of property.

Hardman, 827 F.2d at 1413. In our case, repayment is tied to the sale of units in a development. The second factor therefore also appears to favor finding debt.

The third factor is also difficult to apply in this case. The third factor favors equity treatment if the source of payment comes from general earnings and profits, but favors debt treatment if the payment comes from the sale of a particular tract of land. Hardman, 827 F.2d at 1413. In our case, because [redacted] was engaged in the activity of developing real estate, the payments came from both the sale of particular tracts of land and from profits. It is only because [redacted] labeled nearly all of its distributions and other incoming cash flows as interest or management expenses that it did not have tremendous profits. The third factor does not clearly point in any one direction.

The fourth factor supports a finding of debt. The taxpayer and [redacted] could compel [redacted] to pay interest when [redacted] had distributions from [redacted]. The ability to enforce payment, even if payment is contingent upon the sale of property, supports a finding that the taxpayer and [redacted] had a right to enforce payment. Hardman, 827 F.2d at 1413.

The fifth factor is inapplicable. Whether there is participation in management depends on whether the transfer increases the stockholder's interest in the corporation. Because all the shareholders of [redacted] advanced funds to [redacted], the advances could not have changed their relative interests as a practical matter.[7]

The sixth factor supports a finding of equity. [redacted] had other indebtedness to the taxpayer. These loans were recourse, with a fixed interest rate and therefore, as a practical matter, higher in priority than the advances at issue. Because the advances at issue were lower in priority, the sixth factor suggests that the advances were equity.

The seventh factor supports a finding of equity. The taxpayer and [redacted] pinned their hopes to the fortunes of the real estate development activity rather than a stream of income, as evidenced by the terms of the notes. In addition, the amounts of the payments made by [redacted] to the taxpayer and [redacted] more closely follow their relative equity interests

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[7]Although the taxpayer was only a [redacted]% shareholder of [redacted] at the time the original notes were signed, the Second Letter gave the taxpayer the option to repurchase the [redacted]% of [redacted] it had just sold to [redacted].

than the amounts of money which they advanced pursuant to the notes.[8]

The eighth factor favors a finding of equity. The ratio of debt to equity, if the advances are viewed as debt, would be approximately [redacted] to [redacted]. The corporation was not adequately capitalized. Moreover, the money which [redacted] advanced to [redacted] was identified as part of [redacted]'s original capital requirements in the Second Letter. The taxpayer and [redacted] knew at the inception of the venture that [redacted] was inadequately capitalized.

The ninth factor is neutral. At first blush the factor may appear to favor a finding of debt. The advances made by the taxpayer and by [redacted] were not in proportion to their existing capital interests. The advances, however, dwarfed their initial capital investments in size. The ninth factor is therefore not a reliable indicator of the character of the advances.

The tenth factor, whether the payments came out of dividend money, is essentially the same as the third factor. Like the third factor, the tenth factor is neutral.

The eleventh factor heavily favors a finding of equity. Without the advances, [redacted] clearly was undercapitalized and could not have been a viable business. Given the enormous risk reflected in the terms of the notes in this case, no commercial lender would have risked any money in the venture at issue.

Thus, four factors seem to favor a finding of equity, three factors seem to favor a finding of debt, and four factors are neutral. We cannot arrive at our conclusion, however, by simply adding up factors. [redacted]

, (b)(5)(AC)

[redacted]

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[8]The ratio of the amounts advanced by the taxpayer and [redacted] pursuant to the notes was exactly [redacted] to [redacted]. The ratio of the capital contributions of the taxpayer and [redacted] was exactly [redacted] to [redacted] without taking into account the advances. The ratio of the capital contributions of the taxpayer and [redacted] was approximately [redacted] to [redacted] if the advances are viewed as equity. The ratio of contingent interest payments, as stated in both the original and revised notes, was approximately [redacted] to [redacted].

[9]Because [redacted] obtained the money it advanced from the taxpayer, it is clear that the taxpayer was in a

[redacted] , (b)(5)(AC)

, (b)(5)(AC)

D. **Treating Interest as Being Usurious**

The original and revised notes provide that to the extent that interest payments would violate California's usury laws, they would be reclassified as principal.[10] California's constitution provides, with several exceptions, that a lender may not charge interest at a rate higher than 10%. Cal. Const. art. XV, § 1. California's courts, however, recognized an exception to a prior version of this rule where the interest is subject to contingencies such that the interest is subject to a hazard over and above the risk which exists with all loans. Thomassen v. Carr, 58 Cal.Rptr. 297 (Cal. App. 1 Dist. 1967). Because the interest and principal in our case was subject to such obvious hazards, we cannot say under the Thomassen rule that the interest provisions of the notes were usurious. We have found no California cases which discuss contingent interest following the enactment of Cal. Const. art. XV, § 1. The Thomassen case, however, should remain good law, because Thomassen did not rely on the specific language of the predecessor of art. XV, § 1, and because nothing in art. XV, § 1 seems to change the Thomassen rule. Furthermore, if we were to rely on the usury provision, we would be lending credence to the taxpayer's contention that the advances were loans rather than capital contributions. Thus, [redacted] , (b)(5)(AC)

II. Accrual of Expenses

[redacted] accrued and deducted interest expense for the contingent interest for the period ended March 31, [redacted]. It appears that [redacted] somehow determined the interest expense by reference to book income and not to any actual interest liability. [redacted] did not actually pay any contingent interest to its shareholders during the taxable year ended March 31, [redacted]. Moreover, pursuant to both the original and revised notes, [redacted] was not obligated to pay any contingent interest until it received a distribution from [redacted]. [redacted] did not receive any distributions from [redacted] during the taxable year ended March 31, [redacted].

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position to completely dictate the terms of the notes.

[10]The notes do not say what happens if [redacted] runs out of principal to repay.

Treas. Reg. § 1.461-1(a)(2)(i) provides in part that under the accrual method of accounting, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. In our case, [redacted] did not become liable for the interest payment until it received a distribution from [redacted]. Because [redacted] was not liable to pay any interest to the taxpayer or [redacted] until after March 31, [redacted], [redacted] may not deduct the interest for the taxable year ended March 31, [redacted].[11]

III. <u>Potential Taxpayer Arguments</u>

The issue in this case would disappear if the taxpayer were to establish that [redacted] should be disregarded as a separate taxable entity. Elimination of [redacted] would of course eliminate the layer of corporate tax which causes the adjustment in this case. We should therefore not be surprised if the taxpayer were to argue that [redacted] should be disregarded. If the taxpayer makes such an argument, we recommend that you contact this office immediately for further guidance.

The taxpayer has contended that much of the contingent interest paid to [redacted] represented compensation for services. You have pointed out, however, that the Second Letter provided that neither the taxpayer nor [redacted] would be entitled to any compensation for services beyond that set forth in the letter in the absence of a subsequent written agreement or a provision of the Joint Venture Agreement allowing for additional compensation. The Joint Venture Agreement does not contain such a provision, and you have indicated that the parties never entered into a subsequent written agreement for additional compensation. The Second Letter therefore contradicts the taxpayer's contention that some of the contingent interest paid to [redacted] was really compensation.

We recommend, nonetheless, that you (b)(5)(AC) [redacted]

[11] This is a grounds for disallowing the interest deduction in addition to previously described grounds.

, (b)(5)(AC)
, (b)(5)(AC)
[redacted]

, (b)(5)(AC)
, (b)(5)(AC)
[redacted]

Should you have any questions about this advice, please call Attorney Andrew Lee at (949) 360-3465. After April 2, 1999, if you should have any questions, please call Assistant District Counsel June Bass at (949) 360-2683.

/S/

ANDREW H. LEE
Attorney